Prospering On Crime: Money Laundering And Financial Crises

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In 1998, the International Monetary Fund estimated that, worldwide, illicit funds amount to between $800 billion and $2 trillion, from two to five per cent of the world's GDP.[1] These facts are no longer a great surprise. Leading journals have recently published articles on the magnitude and processes of money laundering.[2] The incredulity of those who act as if they are just discovering corruption in emerging nations brings to mind the police officer in the film *Casablanca,* who is shocked to find gambling in a casino. Instead of condemning such open secrets, public officials ought to investigate how illicit profits are recycled into the legal economy, the consequences of prospering on crime. What, for example, is the relationship among offshore companies recycling **"**dirty money**,"** the Central Bank of Russia, the Bank of New York, governments of developing countries, and the vicissitudes of international financial aid ? The answer is hardly self-evident. But an increasing body of evidence suggests that there is a link between money laundering and financial crises.

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The post-Cold War financial system rests on two assumptions that fracture one another**.** The first is that free capital flows, like international trade, optimize the allocation of global resources. This assumption is dubious, both theoretically and empirically**.**[3] Although the massive increase in direct foreign investments has contributed to economic development in the South, the larger bank loans and other short-term financial instruments have produced the opposite effect, diverting investment from productive sectors to areas of potentially rapid capital appreciation, such as highly speculative stock

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1 William F. Wechsler, "Follow the Money," *Foreign Affairs*, July/August 2001, 45.
2 William F. Wechsler, "Follow the Money," *Foreign Affairs*, July/August 2001; Nigel Morris Cotterill, "Money Laundering," *Foreign Policy*, May/June 2001. Nigel Morris Cotterill is editor of *World Money Laundering Report.*
3 Jagdish Bhagwati, "The Capital Myth," *Foreign Affairs*, May 1998.

markets and real estate.[4] This activity damages the export competitiveness of developing countries, the supposed basis for repaying foreign loans. Moreover, increasingly frequent recourse to foreign loans for the purpose of financing public debt (supposedly to reduce the risk of inflation), aggravated the risk of currency crises and default on loans in Mexico, Russia, and Turkey.

The second assumption is that the legal and institutional infrastructure that enabled free financial flows between North America, Europe, and Japan were of secondary importance. In the post-Cold War euphoria, decision makers accepted uncritically the idea of a self-regulating market. They underestimated the importance of legal standards that were instrumental to the development of the capitalist economy over the last two centuries as well as the significant burden imposed by the lack of such institutions in transitional economies. The co-existence of free international capital flows and national institutional and regulatory systems created a void in which transnational economic and financial delinquency flourished.[5] Transitional economies privatized state-owned firms without allowing market competition or creating the necessary institutional and legal infrastructure for effective markets. Tax evasion accounts for the most important share of crime; however, other problems include capital flight in countries where exchange controls are inadequate, counterfeiting (which represents, according to the OECD, six percent of world commerce), insurance fraud, and contraband. Thus, corruption grows with new opportunities in North-South exchange and in the legal void of countries in transition, which, although instituting privatization policies, accept the market economy's idea of profit but not the complementary ideal of market competition.

The Growth of "Grey" and "Black" Markets

The sizeable development of the "gray economy" in the context of finance-driven globalization favored the spectacular expansion of offshore markets and tax havens, through which nearly half of the world's money supply currently is funneled. In 1979, there existed only 75 offshore funds. Today, they number more than 3,000. These havens institutionalize tax evasion, especially by the world's great fortunes, a third of whose holdings, estimated at $5.5 trillion (or 18 percent of the world's GDP), are placed in offshore funds.[6] Sheltered from central bank supervision, these new extra-territorial spaces are the home of choice for hedge funds that manage some two-thirds of their assets from tax havens.[7] Although all hedge funds combined amount only to some $300

[4] China, in this respect, is an exception because it focuses on foreign direct investment and relies marginally on short-term capital flows. See Alejandro Lopez-Mejia, "Large Capital Flows: A Survey of the Causes, Consequences, and Policy Responses," *IMF Working Paper*, 1999.

[5] Jean de Maillard, *Un monde sans loi, La criminalité financière en images*, Paris: Stock, 1998.

[6] Guilhem Fabre. *Criminal Prosperity: Drug Trafficking, Money Laundering and Financial Crises after the Cold War.* RoutledgeCurzon, 2003, 77-8.

[7] Barry Eichengreen and Donald Mathieson. *Hedge Funds and Financial Market Dynamics*. IMF, May 1998.

to $400 billion, rather a small about compared with the $26 trillion of the major financial institutions (insurance firms, pension funds, banks), they have privileged access to credit, and this multiplies risks to the financial system. In the fall of 1998, the last-minute rescue of Long Term Credit Management (LTCM), a Wall Street darling located in Connecticut, but officially headquartered in the Cayman Islands,[8] proved to the world that a single institution with assets of less than $5 billion could threaten the entire financial system by taking positions in excess of $200 billion, thanks to the credit received from major banks and brokerages.[9]

Globalization has been accompanied not only by the growth of the gray economy but that of a black economy as well. According to the United Nations, organized and unorganized crime now generates annual sales on the order of 3 percent of the world's GDP, about $1 trillion, half of which is in drug sales, which have boomed over the last decade, stimulated by an abundant supply and diversification into synthetic narcotics.[10] Other profits from crime are drawn from multi-service activities, such as the control of legal and illicit gambling establishments, the arms trade, human smuggling, trafficking in body organs, car theft, prostitution, and racketeering. These profits boost demand for money laundering, which favors offshore markets because of their secrecy and immunity from legal oversight.

In response to the demand for money laundering services, tax havens and offshore markets have developed into international hubs for three kinds of *illegal legality:* 1) the white economy of banks, investors, and fund managers; 2) the grey economy of tax evasion and corruption; and 3) the profits that organized crime seeks to recycle. The boundaries among these three domains are nebulous since the illegal activity occurs prior to transfer of funds to offshore markets. In addition, it is usually impossible to distinguish between tax evasion and profits from crime because the recycling techniques are identical[11].

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[8] Robert M. Morgenthau, "On the Trail of Global Capital," *The New York Times*, Sept. 11, 1998.

[9] Franklin R. Edwards, "Hedge Funds and the Collapse of Long-Term Capital Management," *Journal of Economic Perspectives*, Spring 1999.

[10] *World Drug Report*, United Nations International Drug Control Programme, Oxford University Press, 1997, 123-43.

[11] Nigel Morris-Cotterill, "Money Laundering", *Foreign Policy*, May/June 2001.

The Functions of Money Laundering

Beyond the evasion of legal regulation, offshore markets in the post-Cold War period are all the more threatening because money laundering has played a significant role in the financial crises of nation states. The experience in Russia, recorded in abundant detail through a sequence of scandals closely tied to political back stabbing, suggests that there are intricate links among capital flight, embezzlement, racketeering, pillaging of public assets, corruption, and organized crime. As I have demonstrated in a recent study, significant profits derived from organized crime and corruption were deposited in Swiss banks and re-invested in Russia in order to finance the growing national debt.[12] Corruption and criminal activities played a major part in creating public debt and diverting funds to speculative overseas financial markets: the Russian Central Bank estimated that US$74 billion was transferred from Russian banks to offshore accounts in 1998, the year of the devaluation.[13] A predatory, kleptocratic, and, in the end, Mafia-style pattern of abuse created substantial demand for money laundering on international capital markets, including the demand for Russian Treasury bonds, and was an important factor in the Russian financial crisis of 1998.

Other examples exist as well, which are typically overlooked in neoclassical economic analyses that remain limited to empirical testing of limited models. Yet such examples reveal the sometimes incestuous relationship between the laundering of “funny money” and financial crisis. The Mexican crisis of 1994-1995, and the “tequila effect,” or the repercussions that it triggered in Latin American countries through the regionalization of exchanges, can only be understood if the “cocaine effect” is also taken into account. Starting in the 1990’s, Mexican drug dealers took charge of one-half of the Colombian drug trade to the United States, and thereby repatriated some US$3 to 8 billion per year, which exceeded the value of Mexico’s oil exports.[14] Some of these funds went to the ostentatious consumption of luxury goods from the United States, thereby increasing the country’s dependence on imports. The remainder was recycled into small businesses, luxury real estate, and the securities and grey currency markets, which levy some 10 to 15 percent for their money laundering services. The hasty privatization initiated by Carlos Salinas also provided opportunities for recycling narco-profits, especially in the banking sector, where the state sold a series of firms for US$12 billion. After the crisis, these banks were saddled with debts in excess of US$60 billion, which were subsequently assumed by the state.

In Mexico, money laundering was combined with international short-term capital flows to create excess liquidity, and a stock market and real estate bubble. Although at the outset they corresponded to only 1 to 3 percent of GDP, the mass of narco-dollars managed to distort competition to the advantage of organized crime in small business and banking. The “laundering premium” that they earned made it possible for them to be more competitive and, on occasion, to absorb their competitors, while emphasising short-

[12] Guilhem Fabre, *op.cit*, 163-64.
[13] William F. Wechsler, *op.cit.*, 47.
[14] For more details on Mexico, see Guilhem Fabre, *op.cit*. ch. 5.

term speculative investments. Moreover, their access to credit made it possible to recycle and to expand capital of dubious origin. Far from improving the general competitiveness of the export economy or helping to reduce external debt, laundering accentuated imports of consumer goods and emptied the productive sphere in favor of short-term investments. The injection of narco-dollars thus contributed to the deterioration of foreign trade and precipitated payment(s) defaults, devaluation, and the financial crisis of 1994-1995.

As in Russia and Mexico**,** the Thai crisis, which triggered the Asian crisis of 1997, is no stranger to money laundering. According to a study published in 1997 by three researchers at Chulalongkorn University,[15] at the onset of the crisis, the equivalent of 8 to 11 percent of the Thai GDP was controlled by organized crime, which derived its profits mostly from gambling and prostitution, and also from drug traffic out of Burma.

Accelerated democratization of the Thai political system during the 1990s gave a clear advantage to the provinces rather than the Bangkok region. Bangkok was the stronghold of the modernist democratic party and generated half the country's GDP. The peripheral regions were under the control of local "godfathers," frequently of Sino-Thai origins, who combined certain legal monopolies with illegal activities, such as gambling, prostitution, drug trafficking, and contraband in wood and precious stones. When the provinces acquired the decisive role in fragile government coalitions, political patronage encouraged money laundering**.** Once again, it focused on speculative real estate and stock market investments in a context of insider trading scandals that occurred in the course of privatization.

As in Mexico, the inflow of foreign short-term capital, most often transited through the Bangkok Offshore Banking Facility, accelerated local speculation by limiting investments at the expense of the productive and export sectors. The ensuing deterioration of the external accounts was aggravated by the rise of the dollar and the slowdown on the electronics export markets in 1996.[16] This combination of events precipitated the exchange crisis and the devaluation of the baht. But the pressure created by short-term investments or by the results and figures in the formal economy does not explain the magnitude of the crisis. The local political and financial system also played a part, in that it strongly favored the laundering of profits from crime. By the end of 1999, two years after the crisis, whereas the Thai GDP had contracted by 10 percent in 1998 alone, and the surplus on the real estate market was estimated at 300,000 units in the Bangkok region, real estate prices did not fall.[17] This stability remains incomprehensible if one analyzes real estate prices according to traditional market criteria, but the puzzle disappears when one factors in the need for money launderers to funnel massive amounts of funds into real estate, as well as the delays which they caused in the reconstruction of the financial sector.

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[15] Cf. Pasuk Phongpaichit, Sungsidh Piriyarangsan, Nualnoi Treerat. *Guns, Girls, Gambling, Ganja: Thailand's Illegal Economy and Public Policy*, Chiang Mai: Silkworm Books, 1998.

[16] For more details on the Thaï crisis, see Guilhem Fabre, *op.cit*., ch. 6.

[17] Odile Cornet, *Le MOCI (Moniteur du Commerce International)*, 3/11/99.

Japan: The Yakuza Recession

The role of money laundering is also evident in developed economies, for example, in Japan, the world's second largest economy. To understand the yakuza's social legitimacy, Curtis Milhaupt and Mark West have shown that, "in Japan, the activities of organized criminal firms closely track inefficiencies in formal legal structures, including both inefficient substantive laws and a state-induced shortage of legal professionals and other rights-enforcement agents."[18] The role that the yakuzas played in the speculative bubble of the 1980s is now known.[19] Through their control of drug traffic, prostitution, employment in the building sector, and public works, as well as a part of the very lucrative business of pachinkos—those electric billiard games generate one and a half times the turnover of the Japanese automobile sector (some 6 percent of the GDP)—organized crime has invaded the real estate co-operatives (*jusen*), the leading brokerages, and the shareholders' meetings of certain large companies.[20] Their access to credit enables them to launder their illicit profits in speculative businesses, where they tend to prefer high-risk operations. When the speculative bubble burst at the beginning of the 1990s, stock and real estate prices dropped, and bad debts swamped the banks and other financial institutions. The former director of the National Police Agency, Raisuke Miyawaki, estimates that 10 percent of these debts are yakuza-related and an additional 30 percent have probable links with organized crime, which would put such non-recoverable debt attributable to gangsters at somewhere between $75 and $300 billion, that is, 6.5 percent of GDP.[21]

After having speculated on the upside, the yakuzas then speculated on the downside, trying to buy up real estate assets at fire sale prices and by blocking, through targeted operations, the liquidation of the liabilities of certain firms which resort to the yakuzas' illegal services in order to escape their engagements. This fact explains why the fall in real prices of real estate, between 30 to 70 percent since the beginning of the 1990s, *did not coincide with a corresponding rise in transactions*, and thus retarded the reconstruction of the financial sector, the supply of credit, and, in the end, new growth. Other factors exist that explain Japan's economic difficulties; however, the "yakuza recession," in the words of Raisuke Miyawaki, should not be taken lightly. Despite the government's numerous expansionist policies, which increased the GDP by several percentage points, the exceptional length of the Japanese crisis is fully understood only when one takes account of money laundering and the activities of organized crime. These socialized the costs and privatized the profits of organized crime, thereby

[18] "The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime," *The University of Chicago Law Review*, 67, winter 2000, No. 1.
[19] Philippe Pons, *Misère et crime au Japon du 17ème siècle à nos jours.* Ed. Gallimard, Bibliothèque des Sciences Humaines, 1999.
[20] For more details on Japan, see Guilhem Fabre, *op.cit*., ch. 4,"The *Yakuza* Recession."
[21] Velisarios Kattoulas, Miyawaki even estimates that "up to 50 percent of the bad debt held by Japanese banks could be impossible to recover because they involve organized crime and corrupt politicians." See "The Yakuza recession," *Far Eastern Economic Review*, January 17, 2002.

distorting the competitive environment. From 1985 to 1995, the Japanese GDP grew by 52 percent, while all financial assets grew by 85 percent. The difference between these two figures demonstrates the persistence of the speculative bubble,[22] which centered in the real estate market, the yakuzas' sector of choice for their invisible maneuvers, which delay market adjustment.

September 11th and Beyond

The cases of Russia, Mexico, Thailand, and Japan do not prove that there exists an automatic link between money laundering and financial crises. The argument would be strengthened by further research on other examples of financial crises, such as those of Argentina, Turkey, and Nigeria in 2000-2001. But the accumulation of such crises and their probable links to money laundering demonstrate how the forces that prosper from crime—however marginal in comparison to the formal economy—can provoke decisive political repercussions.

Although it is clear that the masses in the Arab world have been subdued—under humiliating conditions—by Western nations and by their own governments, the September 11th massacre does not reflect an act of revenge to this state of affairs. On the contrary, it illustrates, with unprecedented drama, the political strength of criminal networks, whose power, in this case, stems from the systematic destruction of enlightenment Islam, and the symbolic manipulation of a sect of *wahabi* origin, supported by rent-seeking families of Saudi Arabia.[23] In this sense, the sound and fury sparked by the war in Afghanistan is a striking contrast to the veil of silence surrounding the financial investigations into the speculative maneuvers in the United States, London, German, French, and Italian stock markets launched just days before the attack by apparent accomplices.[24] Yet political will and political means must overtake this dual system, where the methods of supervision and the rules of the game are at least a decade behind the rapidity of financial flows and the existing capacities for circumvention. Without significant changes in the regulatory superstructures of financial institutions worldwide, the links between those who prosper from crime, money laundering and financial crises are likely to proliferate, protected by the fear they inspire and the silence they maintain.

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[22] Teruhiko Mano, "New Moves in the Money and Capital Markets," *Japan Review of International Affairs*, No. 4, Winter, 1998.

[23] Fethi Benslama, "Islam: quelle humiliation?" *Le Monde,* November 28, 2001.

[24] These movements, which are highly sensitive in the markets for derivatives, have been described by Jacques Follorou (*Le Monde*, September 19, 2001), Martine Orange and Eric Leser (*Le Monde*, September 29, 2001). Tommy Helsey, President of the London branch of Kroll Associates, argues that there is no doubt about the role of terrorists in financial affairs, and their links with other criminal activities such as drugs and arms trafficking. He also suggests that the secretive nature of the hedge fund industry makes it an ideal place for such operations (Marco Magrini, *Il Sole/24 Ore*, Milano, translated in *Courrier International*, No. 569, September 27, 2001, 56.)